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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET DOMINANT PRODUCTS	)))	Docket No. RM2017-3

COMMENTS OF THE AMERICAN FOREST & PAPER ASSOCIATION
(March 20, 2017)

Pursuant to Order No. 3673, the American Forest & Paper Association ("AF&PA") respectfully submits these comments to better inform and assist the Commission in its 10 year review of the system for regulating rates and classes for market dominant products. AF&PA submits that the Commission's task in this proceeding is not to evaluate whether the current system of regulating market dominant rates has furthered each Objective of the statute in isolation, but whether it has properly balanced the multiple aims of the statute, including providing incentives for the Postal Service to increase efficiency, providing predictability and stability in rates, assuring the Postal Service adequate revenues, and maintaining a high quality of service. As explained below, AF&PA contends that the existing system provides the best framework for achieving these ends. With a stronger focus on increasing efficiency and improving service, the Postal Service can realize success under the current system and meet the needs of the mailing industry, including the paper products companies that supply the raw materials for print communications and packages carried in the mail.

I. American Forest & Paper Association and the Postal Industry

The American Forest & Paper Association (AF&PA) serves to advance a sustainable U.S. pulp, paper, packaging, tissue and wood products manufacturing industry through fact-based public policy and marketplace advocacy. AF&PA member companies make products essential for everyday life from renewable and recyclable resources and are committed to continuous improvement through the industry's sustainability initiative - Better Practices, Better Planet 2020. The forest products industry accounts for approximately 4 percent of the total U.S. manufacturing GDP, manufactures over $200 billion in products annually, and employs approximately 900,000 men and women. The industry meets a payroll of approximately $50 billion annually and is among the top 10 manufacturing sector employers in 45 states. We are an integral part of the fabric and economies of the communities in which we operate, many of which are in rural areas where similar job and economic opportunities do not exist.

The Postal Service is an important part of the American economy and the paper industry in particular. Our members and our customers depend heavily on getting our products and messages delivered to the final destination in a secure, timely and cost effective manner. The paper industry has a large stake in the future success of the United States Postal Service. Approximately 39 percent, or nearly $6.5 billion, of the communications papers manufactured by the industry are delivered through the mail system. In addition, the packaging sector of our industry is becoming an increasingly important part of the Postal Service growth strategy for package delivery service driven by the surge in e-commerce. Total shipping and package volume increased by over one billion pieces between 2011 and 2015.[1] We depend on the Postal Service as an essential component of our nation's economic engine which, according to a recent Mailing Industry Jobs study, supports $1.4 trillion in mailing industry revenue and employs over 7.5 million people. The Postal Service is a uniquely American enterprise as it has the infrastructure to enable our customers, which include printers, direct mailers, publishers, ranging from

[1] *See* "A decade of facts and figures," https://about.usps.com/who-we-are/postal-facts/decade-of-facts-and-figures.htm (indicating Total Shipping/Package Volume, including Priority Mail, Priority Mail Express, First-Class Packages, Package Services, Parcel Return Service and Parcel Select, of 3.3 billion in 2011 and 4.5 billion in 2015).

multinational to mom and pop companies to connect and conduct business with every household in this country through printed communications. The success of the Postal Service and the mailing industry is therefore vitally important to the success of the paper industry.

II. Summary

When Congress enacted the Postal Accountability and Enhancement Act, it did so to prevent the "death spiral" many observers predicted for the Postal Service in which "declining business leads to higher rates which in turn leads to decline in business until it is too late to change course."[2] The key feature of this reform was a price cap that limited annual postage increases to the rate of inflation as measured by the Consumer Price Index ("CPI"). Under this cap, the Postal Service would no longer be able to react to declining revenues simply by raising rates. Instead, it would be required to focus on improving its business model by cutting costs and increasing efficiency. To protect against the situation in which the Postal Service would simply reduce service levels to cut costs and retain profits, Congress required the Postal Service to establish and "maintain high quality service standards."[3]

PAEA, and the system of regulating rates the Commission established pursuant to the statute, was a significant improvement over the pre-existing system of cost of service regulation. Yet the Postal Service is now seeking to do away with this innovation. Postmaster General Brennan argued to Congress that "[t]he current cap has failed because it limits price increases simply on the basis of household inflation" and that the Commission should "review and replace

[2] Cong. Rec. H6513 (Rep. Davis comments on H.R. 22, a predecessor to PAEA) (July 26, 2005); *accord* Cong. Rec. S11674 (Sen. Collins, in supporting PAEA, referring to a Government Accountability Office description of "a potential death spiral in which escalating rates lead to lower volume, which in turn leads to even higher rates, which in turn causes the Postal Service to lose more business.") (Dec. 8, 2006).

[3] 39 U.S.C. § 3622(b)(3) (Objective 3).

that system" in the current review proceeding.[4] While it is not yet clear what "a suitable [alternative] regulatory structure"[5] would look like to the Postal Service, it is apparent that it envisions a system of regulation that does not involve a CPI cap.

The Postal Service's position is misguided. Retaining the CPI cap is essential to enable mail to remain a cost competitive option for business communications. Rate stability and predictability are requirements for business to stay in the mail. While AF&PA understands the challenges faced by the Postal Service, the Postal Service and the Commission must recognize that raising prices and reducing service is not a successful strategy to address declining demand. The CPI cap has been an effective mechanism in driving efficiency and has encouraged the Postal Service to cut costs to achieve greater financial stability without jeopardizing long-term demand, and thus the continued viability, of Postal Service mail products. By focusing on improving service and further reducing costs, the Postal Service can succeed under the price cap just as private sector businesses have done under even stricter competitive pressures.

III. Argument

A. The CPI-based Price Cap Enhances the Value of Mail

In evaluating the current system of ratemaking, it is important for the Commission to recognize what makes mail an attractive medium for business communication. The two most important considerations for business mailers are price and service. These considerations work in tandem. When the Postal Service offers a reliable service at an attractive price, businesses will increasingly turn to the mail as an effective channel in their marketing strategy.

In a competitive market, competition provides the incentive for the firm to offer a price and service combination that meets the needs of its customers. The Postal Service, however, does not

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[4] *See* Testimony of Postmaster General Megan J. Brennan before the House Oversight and Government Reform Committee, May 11, 2016, at 5.
[5] *Id*.

operate in a competitive market. It enjoys statutory monopolies over the delivery of most letters and access to the mailbox. It further enjoys *de facto* monopolies, due to its economies of scale and scope, over many products not covered by the statutory monopoly, and over delivery to certain geographic areas.[6] Because of these monopolies, the Postal Service's rates and services have always been regulated to protect users of the mail from the exercise of market power.

Not all systems of regulation are created equal, however. The traditional cost of service regime that governed postal rates prior to PAEA included a "break even" requirement and sought to establish rates at a level at which the postal service recovered its attributable and institutional costs exactly, and no more. This system, like all strict cost-of-service systems of regulation, had a significant flaw—it provided no incentives for the Postal Service to reduce costs, improve service, or innovate. It is textbook economics that allowing a monopoly to automatically recover all of its costs and guaranteeing a single rate of profit (in this case, no profit), "removes all incentives for efficiency, responsiveness to consumer demand, and innovation. Such an arrangement eliminates the profit motive for efficiency and good service to consumers."[7]

By contrast, the current system of regulation and the CPI-based cap create the correct incentives to maximize efficient service and ratepayer value. By replicating the constraints of competition, the current system incentivizes the Postal Service to act efficiently in a monopoly-controlled market. This incentive is extremely important for the overall well-being of the mail industry and the Postal Service as it acts as a substitute for competitive forces that drive innovative and efficient allocation of firm resources. This is not only helpful for maximizing the

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[6] *See, e.g.*, *United States Postal Service v. Postal Regulatory Commission*, 816 F.3d 883, 887 (D.C. Cir. 2016) (upholding PRC's denial of a proposed transfer of the round-trip mailer product to the competitive product category on the basis that Postal Service "does not face any competition in the distribution market")

[7] WILLIAM J. BAUMOL AND ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY at 441 (7th ed. 1998).

service to cost ratio for ratepayers (a key objective and policy goal), but also for ensuring the proper management of Postal Service resources. The CPI-based cap serves this dual goal in a predictable and economically proven fashion.

Removing or raising the CPI price cap would remove these important incentives, resulting in a less efficient Postal Service with lower quality service, substantially harming mailers reliant on Postal Service market-dominate products. This in turn would reduce the demand for Postal Service market-dominant products as substitutes become more attractive. Even a monopolists risks losing business when it raises prices, and it is not true that businesses have no alternatives to the Postal Service for communication. At a high enough postage price (or low enough level of service), alternative channels, especially electronic media, become attractive for most business communications, particularly advertising.

As detailed below, the CPI cap has driven the Postal Service to reduce costs and operate more efficiently, allowing it to realize positive sustainable income. It has, at the same time, protected captive mailers from the exercise of the Postal Service's monopoly power and provided the predictability and stability in rates that they require to make sound business decisions. It has balanced the objectives of PAEA in a way that other regulatory systems could not. In short, it has worked.

B. The Price Cap Has Helped the Postal Service Achieve Financial Viability (Objective 5)

While it may seem counter-intuitive, the CPI-based price cap provides the Postal Service with the best opportunity to achieve sustained financial viability. Without the incentives and cost-control pressure provided by the cap, increasing costs, together with lack of an incentive to increase service quality, could substantially harm the entire market for market dominant products. As noted above, demand for mail is not inelastic in relation to rate changes.

Commercial mailers, which represent 90% of mail volume, are constantly evaluating the relative costs of reaching their customers. Today, postage costs represent 55-70 percent of the cost for mailers to choose print. Accordingly, large spikes in postal rates will likely result in driving significant volumes of mail out of the system. Cost sensitive entities will be priced out of the industry while remaining entities will suppress demand further as they face higher costs without a corresponding increase in value. Market substitutes, such as electronic mail, will become more attractive and replace use of postal products. This reduction in demand will cause overall Postal Service revenue to decline and incentivize the Postal Service to further increase rates to chase diminishing profits, causing an unmanageable and unrecoverable feedback loop where the Postal Service cannot cover costs at the suppressed demand levels.

This combination of rising prices and declining demand was exactly the problem PAEA sought to correct. As the Government Accountability Office ("GAO") noted in 2003, the historical pattern of an immediate volume decline after a rate increase, followed by a rebound in volume the following year, had failed to hold since 2000.[8] Instead, after two price increases in Fiscal Year 2001 and one in Fiscal Year 2002, total "volume at the end of fiscal year 2003 was almost 6 billion pieces lower than . . . in 2000."[9] The GAO cautioned that "[i]n this climate, rate increases may lead to further volume declines, which in turn would necessitate additional rate increases and begin a cycle often referred to as the 'death spiral.'"[10]

Congress explicitly identified the need to stop this "death spiral" as a reason to impose a CPI-based price cap on the Postal Service. Sen. Collins explained that under the pre-PAEA cost-of-service system, the Postal Service "had been at great financial risk" and was on the brink of "a

[8] GAO Report GAO-04-238, *Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings* at 18 (Nov. 2003).
[9] *Id*.
[10] *Id*.

potential death spiral in which escalating rates lead to lower volume, which in turn leads to even higher rates, which in turn causes the Postal Service to lose more business."[11] As noted above, Representative Davis made similar comments when discussing a predecessor bill that also contained a version of a price cap.[12]

The CPI-based price cap was established to arrest this spiral and provide the Postal Service with the efficiency incentives necessary to focus on growing its business by reducing costs and improving service. In large part, it has succeeded. While the Postal Service was, like the entire economy, severely impacted by the Great Recession, it has since rebounded and has been operating profitability for the last several years. For instance, in the first quarter of Fiscal Year 2017, the Postal Service reported $522 million in controllable income.[13] This positive outcome is just the latest iteration of a developing trend; the Postal Service has achieved a total operating profit of $3.7 billion since the start of Fiscal Year 2014.[14] As discussed further below, the net losses the Postal Service has experienced result from Congressionally-imposed mandates that bear little relation to the true revenue needs of the Postal Service.

C. The Price Cap Has Provided Necessary Predictability And Stability In Rates (Objective 2)

The value of the predictability and stability in rates afforded by the CPI-based price cap cannot be overstated. Predictability of rates is extremely important for ratepayers as it allows

[11] Cong. Rec. S11674 (Dec. 8, 2006).
[12] Cong. Rec. H6513 (Rep. Davis comments on H.R. 22, a predecessor to PAEA) (July 26, 2005)
[13] USPS Press Release, "U.S. Postal Service Reports Fiscal Year 2017 First Quarter Results" (Feb. 9, 2017).
[14] Fredric V. Rolando letter to the editor of USA Today (March 7, 2017) (available at (http://www.usatoday.com/story/opinion/2017/03/07/things-bad-postal-service-say/98871900/ (site visited Mar. 15, 2017); *see also* United States Postal Service FY 2016 Annual Report to Congress, Docket No. ACR2016, Library Reference USPS-FY 16-17 2016 Annual Report and Comprehensive Statement of Postal Operations at 15 (displaying positive controllable income every year from FY2014 through FY2016 and a target for positive controllable income in FY2017).

business to make strategic decisions. When they can anticipate when and by how much postal rates will change, businesses can revise budgets and reduce costs in other areas to account for their predicted postal spend. The CPI-based cap is invaluable to this objective, and the current system has been successful in this regard.

Prior to the Postal Accountability and Enhancement Act of 2006 (PAEA), it was not unusual for mailers to see increases well above CPI on irregular schedules. Since PAEA, rates have generally changed (with the exception of the exigent increase) by predictable amounts (and according to publicly available data) at regular intervals. This has helped mail maintain its value as a business communication tool even as digital media has become ubiquitous. Rate stability and predictability are bedrock requirements for business to stay with mail.

D. Maintaining High Quality Service Standards Is Essential (Objective 3)

Consistent and reliable delivery service is imperative for mailers. The value of the Postal Service's products is significantly diminished when mail is not delivered within its service standard. Thus, it is essential that Postal Service maintain high quality service standards that emphasize reliability and predictability (even, if necessary, at the expense of speed). Otherwise, the Postal Service is likely to face further downward volume pressure and financial difficulty. When predictability and reliability is diminished customer complaints rise, subscriptions face risk of cancellation, and advertisers consider alternative media. Thus the costs of poor service to the sender is unmanageable when reliability is compromised. The Postal Service must find a way to maintain or improve reliable delivery service to maintain a viable market of its products.

Reducing levels of service in a backdrop of declining demand is not a winning strategy. Direct mail makes good business sense, as evidenced by research findings reported by the Data and Direct Marketing Association, which found that the response rate for direct mail catalogs was 35 times greater (4.26%) than that for e-mail, which had responses of 0.12%. But if a mailer cannot rely on a direct mail piece arriving in-home in a timely manner, the difference in response rates between mail and e-mail becomes less meaningful. A consumer can only respond when a mailpiece is in hand. Further, predictable, reliable service allows mailers to staff call centers, ensure inventory, prepare for fulfillment, and take other actions that ensure a successful print campaign.

The Postal Service has struggled with service quality in recent years. As the Public Representative noted in its comments on the Fiscal Year 2016 Annual Compliance Report, within Standard Mail, "only High Density and Saturation Letters, and Parcels, exceeded service performance targets" during the fiscal year, and while in some respects service improved relative to FY2015, service for many products – Standard Mail Carrier Route, Flats, and Every Door Direct – was substantially below targeted levels.[15] Perhaps more worrisome, the Public Representative complained that the Postal Service has "provided sparse detail of its efforts to improve service performance in its FY2016 ACR filings. Because the Postal Service's filings lack detail, and really say nothing new compared with previous years, it gives the appearance that service performance issues are not being taken seriously."[16] These performance issues impact the value of mail and, if left unchecked, could cause the Postal Service's financial performance to decline.

There is significant risk that if the CPI-based price cap is weakened, service will deteriorate further. Again, the problem is that without the incentives provided by the cap, the Postal Service will not take the actions necessary to improve service quality. If the Postal Service is simply allowed to raise rates to compensate for declining volume, it will not have the incentive to try to grow volume by improving service. By signaling its intent to maintain a firm price cap

[15] Docket No. ACR2016, Comments of the Public Representative at 4.
[16] *Id*.

while focusing on service improvement, the Commission can play a significant role in encouraging the Postal Service to focus on what will truly improve its business—providing better, more reliable service to mailers.

E. The Commission Should Not Attempt To Resolve Financial Issues Created by Congressional Mandates

The most significant financial issues faced by the Postal Service are unrelated to its ability operate profitably under the current ratemaking system and the CPI-based price cap. Rather, they are the result of Congressionally-imposed requirements focused on future obligations. For example, as the Office of Inspector General explained, the $5.5 billion net loss the Postal Service reported in Fiscal Year 2014 was "driven by two requirements that are out of the Postal Service's control: the requirement to prefund its retiree health benefits fund and its workers' compensation expenses."[17] The OIG noted that when one factors these expenses out, "the Postal Service earned $1.4 billion in controllable operating income in FY 2014" and "has earned a total of $1.7 billion in cumulative operating income since 2006" even while dealing with the Great Recession and its after effects.[18]

Because these obligations are outside of the Postal Service's control, they cannot be mitigated by a change to the ratemaking system. In fact, the Postal Service's best opportunity to meet these obligations lies in growing its business by focusing on improving the value proposition it offers to mailers. As explained throughout these comments, the CPI cap provides the conditions that will incent the Postal Service to make the changes necessary to achieve this end.

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[17] USPS OIG Report RARC-WP-15-008, "U.S. Postal Service Revenue: Is the Glass Half Empty or Half Full?" at 1 (Apr. 13, 2015).
[18] *Id*.

Finally, as a practical matter, there is no immediate crisis that would be resolved by providing the Postal Service with additional revenue to meet these prefunding obligations. As Postmaster General Brennan noted in testimony before the House Oversight and Government Reform Committee, "The Postal Service's funded level for [retiree health benefits] far exceeds that of civilian federal government entities, state governments, and private sector companies."[19] Similarly, the Postal Service's pension funding "compares favorably to other entities in both the public and private sectors."[20] Thus, providing the Postal Service with additional revenue to meet its prefunding obligations would not solve a practical problem. It would simply raise prices on captive mailers to overfund future obligations.

F. The Postal Service Could Improve Its Financial Position Further By Reducing Costs and Increasing Efficiency (Objective 1)

The Postal Service can also improve its financial position while still operating under a CPI cap by invoking the full flexibility afforded to it by PAEA. The Postal Service needs to thoroughly assess all the tools available to it—including Negotiated Service Agreements, market tests, and new products—and critically evaluate its options. To the extent the Postal Service has failed to utilize these tools to date, the fault may lie in its focus in recent years on seeking relief from the price cap, first through the exigent price increase and more recently from Congress (and now the Commission).[21] In any industry, the incentives provided by a price cap are only effective so long as the regulated entity understands that the cap will be strictly enforced. So long as the

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[19] House Oversight and Government Reform Committee Hearing, "Reforming the Postal Service: Finding a Viable Solution," Written Testimony of Megan J. Brennan at 12.

[20] *Id*.

[21] *Id.* at 6 (calling for jettisoning of the CPI-based cap); Statement of Postmaster General Patrick R. Donahoe Before the Senate Committee on Homeland Security and Governmental Affairs at 11 (calling for providing the Postal Service with "greater flexibility over pricing" through legislation) (Feb. 13, 2013); Statement of Postmaster General Patrick R. Donahoe Before the Senate Committee on Homeland Security and Governmental Affairs at 9-10 ("We believe the prices of market dominant products should be based on the demand for each individual product and its costs, rather than capping prices for each class at the rate of inflation.") (Sept. 6, 2011).

Postal Service believes it will be relieved from the burden of complying with the cap, it is unlikely to fundamentally reevaluate its business to determine how best to succeed in a price-limited environment.

Perhaps for similar reasons, the Postal Service has not taken the same actions the private sector has taken to adapt to the changing environment and rise of digital media. While it has engaged in some significant cost-cutting efforts and has operated, on the whole, more efficiently under PAEA than it did under the prior act, it still has room to become more efficient. In doing so, it should follow the lead of private industry.

The paper industry is a prime example of an industry that has reacted to competitive and macroeconomic pressures by embracing change and succeeded doing so. Throughout the backdrop of previous recession, global competition, and the shifting consumer preferences of recent years, the paper and packaging industry remains a significant contributor to the economy. In response to a changing market, the paper industry has adapted by realigning infrastructure, redirecting core competencies and seizing new growth opportunities through innovation. Industry companies have re-focused productivity and production to concentrate on the most efficient manufacturing processes. At the same time, worker productivity has increased. Between 2004 and 2014, the average output per man hour at U.S. pulp, paper and paperboard mills increased by nearly 13 percent.

Paper companies have also repurposed facilities to enhance quality, improve efficiency and expand capabilities of manufacturing assets, enabling them to take advantage of opportunities to produce new and value-added products that serve adjacent markets. Examples of such new product developments include flexible printed electronic circuits, embedded RFID components, as well as QR codes and augmented reality applications that link consumers from physical print to digital product experiences.

As paper companies have adapted to changing markets, they have nevertheless kept the needs of their customers at the forefront of their long-term strategy. An example of that industry commitment can be seen through the industry-wide collaboration “Paper and Packaging-How Life Unfolds™” campaign launched last summer. Run by the Paper and Packaging Board, the program aims to remind the public of the importance paper and paper products play in the daily lives of each American, including those products shipped and received through the U.S. postal system.

These new market realities offer both challenges and opportunities for the paper industry, and the same is true for the Postal Service. Private industry has used innovation to find new markets and applications for its products, and the Postal Service must do the same. And just as private industry has adjusted its infrastructure to align with the evolving market realities, the Postal Service must take similar actions to react to changes in mail volume and product mix.

Importantly, when viewed from the lens of private industry, a limitation on price increases tied to CPI is generous. Most private sector businesses do not have the ability to raise their prices in line with CPI. This is especially true of the paper industry, specifically suppliers to the print mailing industry, whose customers are already dealing with postal price increases at CPI (or above, in the case of the exigent increase). Yet private industry has proven its ability to adapt to new realities and competitive pressure. The Postal Service has the tools to do so as well; it simply must embrace them. The Commission, for its part, should not reduce the incentives that would force the Postal Service to do so by weakening or abandoning the CPI-based price cap.

IV. Conclusion

The Postal Service is an important part of the American economy. AF&PA members depend heavily on the Postal Service to ensure their products and messages are delivered to their destination in a secure, timely and cost effective manner. Retaining the CPI cap is essential to enable mail as a cost competitive option for business communications. The cap provides rate stability and predictability, which are required for businesses to stay with mail. The Commission and the Postal Service must recognize that raising prices while reducing service is not a successful strategy to address declining demand. Removal of the cap could result in unpredictable and excessive increases in postage and have a direct and profoundly negative impact on postal volumes, resulting in a "death spiral" where additional price increases are needed to overcome volume that is driven out of the mail stream, thus defeating the primary aim of PAEA.

Ultimately, the existing system of price cap regulation achieves an appropriate balance in meeting the objectives of PAEA "applied in conjunction with" each other. Removing or weakening the price cap would disturb this balance, eliminate incentives to increase efficiency and improve service, and jeopardizes the financial viability of the Postal Service. The Commission should, therefore, find that the current system of regulating market dominant rates is working and should be maintained and direct the Postal Service to focus on improving the reliability of its service, reducing costs, and finding innovative sources of revenue.

Respectfully submitted,

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